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THE TRANSITION TO A MARKET ECONOMY: FINANCIAL OPTIONS

I. INTRODUCTION

The social transformation of Eastern Europe has proceeded much faster, and the destruction of the legitimacy as well as the efficacy of communism has been more complete, than was deemed possible even two years ago. Like all revolutions, this one has not been a reasoned and deliberate process. The rebellion is leaderless, and no coherent view has emerged of the society it aspires to achieve. The purported intent of achieving a market economy is not a clear directive. Because there are many varieties of market economies, the concept is not precise.

The transformation began lacking a serious body of available literature concerning the problems of a transition from a command or planned socialist economy to capitalism -- or even to a market economy, whether capitalist or socialist. As a result, the process has been both rapid and haphazard. Furthermore, there is a great deal of public impatience. It is understandable that there is little tolerance for delayed real results in societies in which so much has been sacrificed for so long to no avail.¹

There is little in the discussion about the salient fact that differentiates market economies, whether conservative-capitalist or social-democratic, from economies based on Leninist-Stalinist principles. That fact is that market economies are financial

¹ It almost seems self-evident that the so-called planned economies were not in any serious sense planned. In serious planning, the interdependent relations in production and consumption are considered. The apparent disregard of the conditions of the labor force and of the environmental impact of industry in the Eastern European economies is *prima facie* evidence that interdependent relations were disregarded, i.e. development was anarchic, not planned.

systems in which some personal incomes are derived from the profits made by industry and trade.

Financial systems consist of institutions, instruments and markets by which commitments are made to allocate future income to fulfill financial contracts. Furthermore, these instruments can be traded; they have prices. Each unit in the economy has a balance sheet in which real and financial instruments are entered as assets. The liabilities of these units consist of financial instruments and the units' net wealth. The units' net wealth is the arithmetic difference of the values assigned to the entries on the asset side and those on the liabilities side. Thus, there are commitments of some units in the economy to make payments in the future to units in the economy which are owned by other units.

The owners of financial instruments expect to receive incomes in the future. These commitments to pay in the future are created in an exchange where money is paid today (or promises to perform are made today) in exchange for legal claims to particular future incomes or cash flows. The cash flows from organizations which operate the economy's capital stock -- above what is needed to meet wage bills, tax bills and purchases from other units, payments to the holders of financial instruments (whether explicit as interest, dividends, and repayments of principle or implicit as in the case of corporate retained earnings) -- are conventionally called gross profits. As a result of the complex of contracts entered into in the past, the cash flows (as defined above) that are realized at any date are allocated among claimants as stated by the stock of outstanding financial instruments and entries on the books of financial institutions.

The claims are accepted as legitimate because the rights to these cash payments were created by prior payments. Rents, interest and dividends are legitimate

because they reflect the money-later part of trades in which "money now" was exchanged for "money later". The money-now is used to pay for investment output, state spending, foreign goods, consumer goods or financial assets. Those who acquire financial instruments from the market, after they have been created in some initial financing transaction, acquire legitimacy for their claims from the original transaction.

It is obvious that questions of the legitimacy of rights to future income can arise in the privatization of a public domain. The difference between the honest homesteader and the Robber Barons in American history comes to mind. The lesson from history is that the privatization of the public domain should be done very carefully, especially if the capital assets in the public domain were created without any explicit or tied private financing. Questions of how to create legitimate titles need to be addressed in discussions of the transformation of Eastern Europe.

In a capitalist economy, investment and positions in capital assets are financed by exchanges of money-now for money-later. The receiver of the money-now presumably uses the funds to invest and has an acceptable answer to the essential banker's question, "How are you going to get the monies to repay me?". The money-now for financing investment also includes earnings retained rather than distributed, since the internal decisions relating to retained earnings presumably pass the same test as external financing. However, we also know that there are many cases where the presumption is unwarranted.

The financial system thus provides for linkages through time. Exchanges of money for well-defined claims to future-money flows are made each day. Furthermore, each day is the future of deals that were struck in the past. The financial structure and the

physical capital assets of a capitalist economy link the present to the past and to the future.

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Because financial linkages in a capitalist economy between the past, present and future are always conjectural, simple linear economic models that ignore money and finance violate the true character of a capitalist economy. In particular, business cycles that are linked to endogenous financial crises, and the payoff from government regulation and intervention which prevent or contain crises and depressions, are not considered in an evaluation of the costs and benefits of a regime when a theoretical structure in which money and finance are ignored is used for policy-making and policy evaluation.³

As a result of these financial linkages, economists are now recognizing that capitalist economies are best modeled as complex, nonlinear, time-dependent systems. It follows that the path through time of capitalist economies is likely to exhibit periods of incoherence, of instability, due to the characteristics of the system rather than to any inept or malevolent shocks.⁴ There have been many different financial structures throughout

² In Leninist-Stalinist socialism, the link of today to the past is through the labor force and the capital assets available for use today, and the link of today to the future is by way of gross investment, labor force development processes and the labor and capital that is carried over.

³ The Savings and Loan crisis in the United States is a result of the gradual deterioration of the regulatory system over the postwar period (1946-80) and an abrupt corrupting of the regulatory system in the 1980's. What is being called a bailout is the use of government fiscal strength to prevent the breakdown of the S&L's from triggering a big depression. Because the government is being operated by those who accept the advice of neoclassical economists -- in neoclassical theory finance and, therefore, money really do not matter -- they know not what is happening and they therefore know not what to do.

⁴ It is well-known that multidimensional nonlinear time-dependent systems are almost certain to generate complex time paths. If economies are modeled as such systems, then fully endogenous incoherent behavior will take place. In such models, runs of coherent behavior are the result of interventions and constraints. The floors-and-ceilings business

history. These financial systems differ in how they affect economic efficiency and stability as well as the distribution of power in the economy. In particular, they can affect the concentration or diffusion of power. Therefore, there are choices that need to be made, options that need to be considered as Eastern Europe addresses questions about the structure of its new financial institutions.

II. THE SURPLUS AND FINANCE

In any economy where investments take place -- or where there is a court, an army, a priesthood or production for the use of foreigners -- the total of wages paid is greater than the wages paid in the production of the consumer goods. To put it simply, the workers producing investment output or those who serve the person of the Prince, also have to eat. As a result, the price of the goods wage earners buy is greater than the labor cost of producing these goods. This elementary relation indicates that there will be a surplus. Gross profits will be earned in the production of consumer goods, and these profits will depend upon the relation between the total wages paid for the production of consumer goods and the total wages paid in the production of investment goods.⁵

cycle models of some 30 years ago can now be generalized. For an exposition of the economics of chaotic systems see W. Baumal and J. Benhabib, "Chaos: Significance, Mechanism and Economic Application" Journal of Economic Literature, Winter 1989. For floors-and-ceilings business cycle models, see J.R. Hicks, A Contribution to the Theory of the Trade Cycle (New York: Oxford University Press, 1949), H.P. Minsky, "Monetary Systems and Accelerator Models" American Economic Review, 1957, and H.P. Minsky, "A Linear Model of Cyclical Growth" Review of Economics and Statistics, 1959.

⁵ For a further explication of these relations, see M. Kalecki, Selected Essays on the Dynamics of the Capitalist Economy (1933-1970) (Cambridge: Cambridge University Press, 1971), D. and S.J. Levy, Profits and the Future of American Society (New York: Harper

In a capitalist economy, the surplus that is forced by investment spending takes the form of profits. Capitalism is characterized by two phenomena that follow from the financial system: the allocation of the gross profits of the economy among claimants, and the financing of sufficient spending, so that the composition of demand generates a surplus, i.e. profits.

At the level of the individual unit and the particular financing deal, the financing of investment takes place because a pro forma -- a projection of revenues, costs and cash flows -- convinces the businessman and the financier that the project will be profitable. The businessman answers the financier's question, "How will you get the monies to meet the obligations to pay you are accepting?", by pointing to the prospective cash flows.

Assumptions about future economic conditions underlie these pro formas. When the construction and land development deals that have undone the S&L's in the United States were entered into, a not-unusual assumption was that oil was heading towards ninety dollars a barrel. A banker's cliché is "I've never seen a pro forma I didn't like", i.e. those seeking financing always present a favorable view of what will take place. In the business of capitalist financing, it is the duty of the banker to be the skeptic. One suspends disbelief when one goes to the theater, but one should not suspend disbelief in the board room where financing decisions are made.⁶ If the aggregate economic conditions

and Row) and H.P. Minsky, Stabilizing an Unstable Economy, (New Haven: Yale University Press, 1986).

⁶ 6. I wish to cite what I call William Janeway's first law, "Entrepreneurs lie." Minsky's corollary is "Bankers also lie."

and the behavior of the local economies that were assumed in the pro formas drawn up in the 1980's were being realized in 1990, the S&L debacle in the United States would not have happened.

The financial system of a capitalist economy allocates the realized surplus to individual claimants, creating interest, dividends and retained earnings incomes. The financial system is used to finance investment, government deficits, import surpluses, and consumer spending in excess of income. The operation of the financial system finances demands that force a surplus out of the economy. Financed investment, financed government deficits, financed trade surpluses and financed consumer spending in excess of consumer incomes all force a surplus which takes the form of money flows. These money flows may or may not be large enough to validate claims to income that are legacies of past financing decisions.

I state these elementary truths in order to make the point that a financial system needs to be created as a socialist economy becomes a market economy. However, the revolution is so profound and so wide that it is impossible to create reasonable or believable pro formas to project future profits for existing enterprises, let alone for new projects. This implies that the financiers will be required to make great leaps of faith. In light of the continuing problems with the recent result of lack of faith in Latin America, leveraged buy-outs and real estate, this seems unlikely. Financing, whether domestic or foreign, in the absence of acceptable pro formas depends upon political considerations. The political considerations will either be domestic, which implies a socialization of the investment process,⁷ or they will be foreign, which implies a dependency status for the

⁷ This phrase consciously echoes Keynes.

newly emerging economies⁸

III. FINANCING SYSTEMS

There are great differences in the financial systems of the various capitalist economies. Furthermore, the financial system in any economy at any time differs from the financial system of the same economy at an earlier or a later date. Financial systems of capitalist economies evolve in response to perceived profit opportunities in financing and refinancing businesses, households and governments, and in adjusting liability structures and portfolios.⁹ Financiers are profit-seeking businessmen and financial innovation is an endogenous phenomenon. Even without the prompting of Professor Schumpeter, J.P. Morgan well understood that the acquisition of market power is the way to acquire assured profits for particular organizations, once the macroeconomic conditions are set so as to generate adequate aggregate profits.¹⁰

⁸ As a result of the great collapse of the financial system between 1929 and 1933, sufficient investment to generate a close approximation to full employment was not being financed on the basis of "believable" proformas generated by private businesses. Keynesian deficit financing was a substitute for private investment in both generating income and forcing a surplus (profits) on the economy. Government guarantees of private financing was a way to generate acceptable proformas so that private financing was available for private entrepreneurs. The seeds of the 1990's S&L debacle, which rest upon the government guarantees of private financing, were planted in the 1930's.

⁹ H. P. Minsky, "Central Banking and Money Market Changes" Quarterly Journal of Economics, 1957.

¹⁰ Joseph Schumpeter The Theory of Economic Development Harvard University Press, 1936, is the classic English translation of a volume that had appeared in German some 30 years earlier.

As a result of the impact of the financial systems of capitalism upon the decisions that can be implemented, the actual operations of a capitalist economy differ from that of the models developed in the formal theory, where the analysis is carried out abstracting from the existence of money. Theories that abstract from money and finance, such as Arrow/Debreau, Arrow/Hahn and even the scribbling of monetarists,¹¹ are poor guides for understanding problems involved in the transformation of the hitherto socialist economies into capitalist economies. Analysis which abstracts from money and finance cannot be expected to lead to blueprints for the design of the financial institutions of newly emerging market economies.

The critical problem that needs to be solved is how to create a monetary and financial system which will facilitate economic development, the emergence of democracy and integration with the capitalist world. In this transition, the control of property needs to move from the planning authorities to decentralized production units (enterprises), and the objective of managements needs to be the earning of profits in the market.¹²

The Heinz Company, the well-known canner of pickles and purveyor of ketchup, used to have a slogan "57 varieties" to describe the wide scope of the products it

¹¹ K. J. Arrow and G. Debreau, "The Existence of Equilibrium for a Competitive Economy" Econometrica, 22,

G. Debreau, The Theory of Value (New York: Wiley, 1959),

K. Arrow and F. Hahn, General Competitive Analysis (San Francisco: Holder Day, 1971),

D. Laidler, The Demand for Money (Scranton, Pennsylvania: International Text Book Company, 1970).

¹² Note that there are models of socialism in which decentralized enterprises seek to earn the best possible profits in decentralized markets. Oscar Lange, "On the Economic Theory of Socialism", University of Minnesota Press is the classic statement.

offered. I used to say that there are as many varieties of capitalism as Heinz has pickles, and that this very variety of capitalism is responsible for the resilience of capitalism. Capitalism is both intermittently fragile and resilient. Even as events show that a particular form of capitalism is a failure -- as the great depression showed that small-government, laissez-faire capitalism was a failure -- other forms emerge. Thus, the emergence of big-government, interventionist capitalism in the period leading up to and after the Second World War was a response to the failure of small-government, laissez-faire capitalism between 1929 and 1933.

This big-government laissez-faire form of capitalism had a successful run of about forty years in the United States. The current problems of American capitalism may be interpreted as the aging of the 1933-36 Roosevelt reformation of capitalism and the futility of attempting to reform that now-aged capitalism by returning to the failed model of the pre-1930's era. European capitalism, in which the use of the state for public purposes is in better repute than in the United States, may be more successful in the foreseeable future because it is more flexible. Japan is off on a different course of a controlled and manipulated market economy, one that seems to need to sustain its flow of profits by massive export surpluses. Japan's prosperity may be very fragile, for it appears to depend upon technical virtuosity and strong export surpluses. Given its acquisition of foreign assets, Japan has to turn into an import surplus economy, if the profit flows of those who owe it money are to sustain the financial assets Japan now owns.

The existence of a wide variety of capitalism and a vast assortment of capitalist financial structures makes more difficult the problem of designing the financial system for the economic order that will form in the newly emerging economies to the east

of the Common Market. It also makes important an understanding of the possible alternative financial structures and their likely impact upon efficiency, development and distribution, as we begin to write on the largely blank slate that is Eastern Europe.

IV. BALANCE SHEETS

A fundamental attribute of capitalist economics is that each unit has a balance sheet and that these balance sheets are interrelated. The capital assets in the economy -- the plants, equipment and land that constitute the basic non human productive capacity of the economy -- are one set of assets in these balance sheets. In the early stages of capitalism -- before the rise of the corporation, and when yeomen or lords owned land and cattle -- the actual real things may well have entered the (implicit) accounts, since accounts were more like inventories than balance sheets. But as soon as the operator or the ostensible owner of assets began to finance part of the "position" in assets with financial instruments that were promises to pay money, the simple enumeration of assets had to be replaced with a valuation of assets. It is convenient to value assets in the same currency unit as the debts are stated.¹³

In a modern capitalist economy, simple private ownership has been replaced with corporate ownership. The proximate owners of capital assets are now corporations. Furthermore, corporations often have complex liability structures. A complex combination of equity shares, bonds, mortgages, leases and bank loans finance the control of the capital

¹³ This sentence echoes Keynes and is a postulate that leads to the liquidity preference theory of interest and asset valuation.

assets that corporations need for production.

In such a modern corporate world, the liability side of the balance sheet has to be interpreted as a claim by other units to cash payments. Liabilities of one unit are assets of another. The various instruments used to finance the position are dated, demand or contingent claims to the cash flows that the operations of the unit generate, operations that depend upon the use of the physical capital assets. The time dimension, which is an essential aspect of capitalism, arises once there are financial liabilities, for unless the claims to cash are all contingent, i.e. they depend upon the performance of the organization that issued the liabilities, the commitments to make precisely defined, dated payments are entered upon before the funds are realized. The performance in the present may or may not validate commitments that were made in the past. These intertemporal and contingent natures of the financial relations of a capitalist economy are the essential reasons why capitalist economies are not likely to behave in a nice equilibrium-seeking manner, and why interventions into markets are often necessary.

The real assets in the balance sheet of productive units are not liabilities of any economic unit. The liabilities that are used to finance these positions are in turn assets in other balance sheets.

The paper world of financial instruments connects various balance sheets. In simple financial worlds, the liabilities of production units would be assets in household balance sheets and households would directly receive the payments committed on these liabilities. In modern capitalist economies, many balance sheets are interposed between firms that are the proximate owners of capital assets and households that are the ultimate

owners of the wealth of nations.¹⁴

The simplest intermediary owner of the liabilities used to finance positions in capital assets are banks, which interpose their guarantees between the operators of capital assets and the owners of bank liabilities. The power of this guarantee has been such that bank liabilities became means of payments, became the money of the economy. The holding of bank liabilities has been deemed to be a secure and necessary part of wealth-holdings. Because of the ways in which the profit-driven creation of the means of payment were able to force surpluses, and because of the instably-inducing consequences of repudiations of the agreement to make payments by banks, central banks were invented as banking became ever more important in the economy.

Because banks had payment commitments to the holders of their liabilities, good bank management led to banks specializing in the financing of commerce, the movement of finished goods through the production process.

In early forms of capitalism and in modern colonial capitalism, the financing of holdings of capital assets and investment took place outside the banking and financial system. Households and partnerships financed capital asset ownership. Specialized financial institutions, such as mutual savings banks (variant form of the savings and loan associations presently of ill repute) and insurance companies, financed some longer-term assets. As technology changed, the need for longer-term financing became more pronounced. The development of specialized financing organizations and markets, the stretching of the banks to finance capital assets, and various state interventions to foster the

¹⁴ There are organizations such as universities with their endowments that are artificial households.

financing of industry, were all responses to the changes in technology and scale.

V. VARIETIES OF FINANCIAL STRUCTURES

It is necessary to examine the options the emerging economies of Eastern Europe have with respect to their financial structure. One fundamental aspect of the economies now emerging from communism is that no significant private wealth exists, even though there are capital assets which are used in production and which at least potentially may earn profits. This is so because the capital assets of the economy -- the power generating plants, the factories, the farms and housing -- are not measured in the unit of account, and liabilities, which are claims to the profit flows these capital assets are expected to earn, are not entered as assets in either household balance sheets or in the balance sheets of intermediaries which in turn have liabilities to households. As there is no really relevant history of profits in the emerging economies, there is no way to generate meaningful values of capital assets.

Furthermore, there is no simple way to create legitimate private claims on future cash flows which, because they are marketable, are priced and therefore represent wealth. This is so because it is not possible to impute the creation of specific capital assets to some specific earlier exchange of money-today for money-tomorrow, by some identifiable class of individuals or financial institutions.

Financial structures of capitalist economies differ in terms of the importance and strength of their respective financial institutions and markets. Banks which are mainly restricted to short-term financing of business and to financing household positions in primary securities and housing will be the dominant form of banking in economies with

strong markets for bonds and equities. This structure may require that there be many individually managed portfolios and that households be willing to invest directly in corporations. Such market-based financial systems require households to believe in the integrity of the corporate structure. They need to believe that the managements of corporations are operating as fiduciaries with respect to the stockholders, i.e. that enterprises are being operated in the interest of stockholders. (Some of the turbulence in Wall Street since the leveraged buy-outs reflects a feeling that business managements often have been operating not as fiduciaries but in their own self-interest.)

In a simple structure which we can conceptualize, banks are restricted to short-term lending operations secured by goods in the production and distribution system. The cash to repay the banks, both the principle lent and interest, will be forthcoming as these goods are sold. In this economy, banks mainly lend to commerce rather than to industry. This restriction of bank assets guarantees that cash flows from the production system to the banking system are forthcoming and do require that new loans have to be made if the level of activity is to be sustained or increased. In this structure, banks do not participate in the financing of positions in capital assets, except as the production of investment output requires financing. Households -- directly, in partnerships, or in closely held corporations -- own the capital stock of the economy.

If a commercial banking structure survives as capital assets become more expensive and as corporations become dominant organizations, the financing of large-scale investments and expensive capital assets requires that an investment banking community first structure the liabilities of firms, then distribute the financial instruments, and finally provide for the trading of the resulting shares and bonds. Corporations are the business

organization form best suited for production that requires large-scale, long-lived capital assets. This capital market/commercial bank structure, which is dominant in the United States and Britain, is but one financial structure option. To work well, a market-based financial structure requires a large, deep and resilient capital market.

The commercial bank/capital market structure initially (historically) has households owning stocks and bonds of individual companies. In the United States over recent years, the significance of the private holder of corporate equities and bonds of large companies has decreased significantly. There has been a great democratization of the ownership of wealth, even though only a small percentage really owns a significant amount of income-earning wealth.¹⁵ Most households that own wealth own it in the form of interests in funds such as mutual funds, pension funds, money market funds, trust funds and insurance reserves, and, in turn, these funds are the major holders of the liabilities of the largest companies.

As a result of the vast accumulations in these funds, a new form of financial capitalism has emerged. The managers of such funds are most important in determining both the form that financing takes, as well as the emphasis of operating firms as they contemplate financing either production activities or asset holdings. The managers of these funds are mainly interested in what has been called total returns, which are the short-term combination of returns as interest and dividends and the change in the market value of the securities in the managed portfolio. The various manias, from conglomeration to leveraged buy-outs, that have swept American capitalism in the past years reflect the power of these

¹⁵ Household wealth in the form of the accumulation of consumer goods and housing is ignored. The emphasis is upon the ownership of wealth in financial forms.

funds. The 1990's version of the capital market/commercial bank financial structure can be called money manager capitalism.¹⁶

Two alternatives to the capital market/commercial bank financial structure can be delineated. One alternative is a financial structure that emphasizes universal banks, banks that have corporate equities in their portfolios and which take a managerial interest in operating firms. The second emphasizes public holding companies, public bodies that own equities and take a managerial interest in the companies whose equities and debts they own.^{17 18}

In a universal bank financial structure, equities of private firms are held in title or in trust by banks. Households own bank liabilities, which may have the characteristics of money or deposit certificates which are funds that are not immediately available to finance household spending. If households own equities in large companies, these equities are often controlled by the banks, as far as voting for directors and the policing of management.

¹⁶ In a well-known passage, Keynes contrasted speculation and enterprise. He remarked that if the capital development of an economy is left to activities of a casino, the capital development is not likely to be done well. The linkage between the seeming decline in the technical dynamism of the United States and the emergence of money manager capitalism is worthy of exploration.

¹⁷ The parallelism between universal banks and public holding companies is noted.

¹⁸ In the United States, the reputation of private capital markets was adversely affected by the great collapse of financial markets over the 1929-33 period. A public holding company, the Reconstruction Finance Corporation was an important part of the depression-containing and expansion-inducing mechanism. As recovery took place, and as the New Deal's reforms made private capital markets once again acceptable, the holdings of the Reconstruction Finance Corporation were sold off.

In the public-holding-company model, the equities of operating companies, which are formally organized as if they were private companies, are held by a public "holding company." The public holding companies finance their position by borrowing from banks, the market and grants from the Treasury.

The 1990's model of the capital market/commercial bank financial structure in the United States has a wide dispersion of claims to capital income -- it may be called a peoples' capitalism -- but a large percent of the claimants to the income and asset value of the liabilities of firms do not own any significant non-housing assets that are the direct liabilities of functioning economic units.

With the emerging dominance of the managed-money funds in the United States, there has been some convergence between the three models. This convergence is also reflected in the United States by a proliferation of government endorsements of private obligations.

VI. THE OPTIONS

Because there is no significant private wealth in the economies emerging from socialism, markets for financial instruments, as well as the potential for market-based financing, are weak. The initial choice of a financial structure is constrained to emphasizing universal banks or public holding companies. Neither the universal bank nor the public holding company should bar the way to the development of small-scale service and artisan industry. Special venture capital holding companies, and small, local and independent banks should be part of the financial structure to facilitate the development of entrepreneurships. The small-scale and artisan industries will be a start on the direct

ownership of wealth. Such industry will require both commercial-type bank financing and venture capital.

Pension funds and private savings in mutual funds should be encouraged. So that private pensions develop, the public social security system should be little more than a guarantee that the aged will not live in dire poverty. Social policy may therefore induce steps towards the money-manager type of capital market relations.

But such steps will be possible only as the public holding company or universal bank models succeed in financing sufficient investment so that firms both large and small are profitable. Proven track records of operating profits are necessary for these firms' assets and liabilities to be valuable.

If the aim is to create a peoples' capitalism in which pension, life insurance and mutual investment funds emerge, then the transition from the inherited socialism to a market economy may well be through the public holding company route rather than the universal bank. This is so because the public holding company can be a temporary holder of assets, holding assets only until such time as the markets become thick enough to absorb them, whereas the universal bank structure is viewed as being permanent.

Both the public holding company and the universal bank financing structures reflect the thinness of private capital markets in countries such as Germany and Italy where they are preeminent. The main problems of transiting from socialism to capitalism are the creation of manageable, profit-seeking firms, the generation of private wealth holdings, and the effective financing of investment. The simplest path is to first transform enterprises into corporations and create a system of public holding companies -- national, regional and local -- which own the equity shares of these corporations. Initially the government owns

the shares of the public holding companies. The holding company directs the subsidiary companies to operate so as to make profits and replaces managements that do not perform.¹⁹ In the initial phase, however, it must to be recognized that even potentially profitable organizations will have losses.

The holding companies will acquire funds to finance investments of their subsidiary units by retaining earnings and by issuing bonds which pay attractive rates and carry government guarantees. Banks may be authorized to take some tranches of these bonds, and banks will finance these positions by issuing deposit certificates that are not immediately available cash. As workers acquire vested pension rights by withholdings from wages, pension funds will provide a market for the liabilities of the holding companies and their subsidiaries. Mutual investment funds need to be authorized on both national and provincial levels that will have portfolios of not only the debts and shares of the public holding companies, but also of the publicly held portions of the subsidiary companies as well as shares of the private companies which have profit records.

The public holding company is to be considered as a transitional device. The model is the previously mentioned Reconstruction Finance Corporation of Roosevelt's New Deal,²⁰ but the transition can be expected to be rather long. It is even possible that a "mixed" economic order will survive, where private firms and public holding companies compete.

¹⁹ This makes the holding company formally similar to the Sloan structure of General Motors, a management structure which was most successful.

²⁰ In truth, the Reconstruction Finance Corporation was put in place during Herbert Hoover's term, a term which virtually coincided with the great contraction of the world economy.

The assets of the public holding companies are the equity shares of enterprises. As particular enterprises begin to make profits, their equity shares will acquire value. The public holding company should slowly sell out its positions in these profitable companies, transforming them into private companies. The pace of privatization is ruled by the rate at which enterprises begin to generate believable profit flows and the rate at which the market for equity assets grows, as individuals and funds acquire the ability to accumulate wealth.

The public holding company route has two virtues as compared to the alternatives. It is flexible, which means that it has the ability to adjust to changing market conditions, and it makes for an orderly transition over a flexible time frame to a modern capitalist financial structure. Furthermore, by allowing for local as well as national public holding companies, it provides for a decentralization that may well be the key to success in an increasingly fragmented political structure.

The alternative is a system of competing universal banks, where households own liabilities of the banks and the banks own liabilities, both equities and debts, of companies. If the banks are publicly owned, then the transfer of enterprise equities to these banks is formally equivalent to the placing of enterprise liabilities in the portfolios of public holding companies.

The virtue of the public holding companies is the decentralization of power. In addition, equity and long-term debt financing are separated from short-term financing through banks.

VII. CONCLUSION

The transition to a market economy requires the construction of a financial system. The simple fact of the matter is that there is no private wealth and there is no effective price level for capital assets in the countries now emerging from the Stalinist epoch. The device of public holding companies is a practical way to operate the economy as the information and private wealth required for a capitalist economy develop.

A question that hasn't been addressed is whether there is sufficient altruism and competence in the affected countries to operate public holding companies. We have to acknowledge that the countries that are now emerging from the Stalinist epoch have never been very successful, either as economies or as democracies.